



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF COUNSEL

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CONEX 121293-02
CC:TEGE

[REDACTED]

Attention: [REDACTED]

Dear [REDACTED]:

This letter is in response to your inquiry dated March 20, 2002, on behalf of your constituent, [REDACTED]. He objects to the tax treatment of municipal bond tax-exempt interest. I am providing the following general information to assist you in your response to [REDACTED].

As a general rule, if the only source of a recipient's income is social security benefits, then those benefits are not subject to income tax. However, a portion of social security benefits may be taxable if the recipient receives other income in addition to social security benefits. Where total income exceeds certain amounts, a part of the social security benefits are taxable.

The Social Security Amendments Act of 1983 added section 86 to the Internal Revenue Code and the Omnibus Budget Reconciliation Act of 1993 amended it. The Congress did not view section 86 as a penalty. The Congress enacted section 86 because it believed the existing policy of excluding all social security benefits from a person's gross income was inappropriate. Social security benefits are similar to benefits received under other retirement systems, which are subject to taxation to the extent they exceed a worker's after tax contributions. Consequently, taxing a portion of social security benefits improves tax equity by treating more equally all forms of retirement and other income designed to replace lost wages (for example, unemployment compensation and sick pay). The phased-in method for taxing social security benefits assures that only taxpayers who have substantial income from other sources will be taxed on a portion of the benefits they receive.

The Omnibus Budget Reconciliation Act of 1993 increased the maximum amount of social security benefits included in gross income for certain higher-income beneficiaries to more closely conform the income tax treatment of these benefits with private pension benefits.

Reducing the exclusion for social security benefits for these beneficiaries enhances the equity of the individual income tax system by treating all income the same. [H. Rep. No. 103-111, 103rd Cong., 1st Sess. 654 (1993), 1993-3 C.B. 320.]

The income tax treatment of social security benefits is governed by § 86 of the Code. Taxpayers must include tax-exempt interest in modified adjusted gross income when calculating the amount of social security benefits that may be taxable. The taxpayer must increase adjusted gross income by the amount of interest he or she received or accrued during the taxable year which is exempt from tax [Section 86(b)(2)(B)]. In explaining this provision, the Senate Finance Committee stated:

This provision does not affect the exclusion for interest on tax-exempt obligations. Rather, it merely includes that interest in the base for purposes of determining the amount of an individual's social security benefits that will be taxed.

[S. Rep. No. 98-23, 98th Cong., 1st Sess. 25, 27 (1983), 1983-2 C.B. 326, 328.]

If a taxpayer is married and files a joint return, the taxpayer and spouse must combine their income and social security benefits in deciding if any part of the combined benefits will be taxable. This rule applies even if one spouse did not receive social security benefits.

Though the tax-exempt interest is not itself taxable, it can cause additional social security benefits to be taxable as a result of adding it to the adjusted gross income to form a larger modified adjusted gross income. If a taxpayer fails to include the tax-exempt interest in the calculation of modified adjusted gross income, he or she may underreport the amount of taxable social security benefits. Thus, the taxpayer may be liable for additional tax, interest, and penalties.

I have enclosed a copy of Publication 915, Social Security and Equivalent Railroad Retirement Benefits, which provides more detailed information on the income tax rules for social security benefits.

I hope this information is helpful. If we can be of further assistance in this matter, please contact me at (202) [REDACTED] or [REDACTED] of my staff at (202) 622-6040.

Sincerely,

Sarah Hall Ingram
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure (1)